IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF COLORADO
The Honorable A. Bruce Campbell

In re:	)	
	)	
D.E. FREY GROUP, INC.	)	Case No. 04-11906 ABC
	)	Chapter 11
Debtor.	)	
_____	)	
	)	
D. E. FREY GROUP, INC.,	)	Adversary No. 05-1356 ABC
	)	
Plaintiff,	)	
v.	)	
	)	
FAS HOLDINGS, INC.,	)	
	)	
Defendant.	)	
_____	)	

RULING ON MOTION TO DISMISS OR ABSTAIN

Before the Court in this adversary proceeding is Defendant FAS Holdings, Inc.'s ("FAS") Motion to Dismiss or Abstain. FAS's motion seeks various relief: (1) dismissal of this adversary proceeding pursuant to Fed.R.Civ.P. 12(b)(3) for improper venue; (2) abstention pursuant to 28 U.S.C. § 1334(c)(1); (3) dismissal of specific claims for lack of subject matter jurisdiction under Fed.R.Civ.P. 12(b)(1); and (4) dismissal of specific claims for failure to state a claim under Fed.R.Civ.P. 12(b)(6). For the reasons stated below, FAS's motion shall be denied, in part, and granted, in part.

BACKGROUND[1]

Plaintiff in this adversary proceeding is D.E. Frey Group, Inc. ("Frey" or "Debtor"), the Chapter 11 debtor in reorganization proceedings in this Court. Frey filed its Chapter 11 petition on February 5, 2004. This Court confirmed the Debtor's reorganization plan on December 15, 2005. That plan centers in large measure on payment of creditors and equity interest owners, in order of priority, to the extent of recovery, if any, on claims against FAS. The Debtor now, and since its Chapter 11 petition was filed, has been without assets except these claims and a fund of some $400,000 that, during the course of these proceedings, was advanced by parties in interest to underwrite litigation of the Debtor's claims against FAS.

[1]The background facts recited are drawn from FAS's Motion to Dismiss or Abstain and the Court's docket in these proceedings.

Prior to its financial difficulties, Frey was a holding company for D.E. Frey & Company, Inc. (the "Broker"), a retail securities broker-dealer registered with the SEC and NASD. In September 2000, the Broker was in a deficit capital position in violation of SEC capital requirements. The Broker was prohibited by its regulators from continuing in the securities business unless it obtained an infusion of capital to remedy its net capital shortage. This it was unable to do, and the Broker ceased doing business.

In order to preserve the value of the Broker's assembled several thousand retail accounts and several hundred affiliated registered representatives, the Debtor entered into an arrangement with FAS in late September, 2000. Pursuant thereto, the Broker transferred non-exclusive rights to service its accounts to the Debtor, who transferred them to FAS. FAS, in turn, transferred the rights to service these accounts to its operating subsidiary. FAS, for its part, agreed to advance funds to the Debtor to pay its outstanding operating costs. These arrangements were later, in July, 2001, memorialized in a Non-Exclusive Account Servicing Purchase Agreement between the Debtor and FAS (the "Contract"). Under the Contract, FAS agreed, under specified circumstances, to make payments to the Debtor in the event of certain disposition of the customer accounts (a "Liquidity Event"). The Contract contains governing law and choice of forum provisions. More specifically, it provides that New York law shall govern the parties' rights and obligations under the Contract, and that the parties consent to "exclusive jurisdiction and venue of the courts of the state and federal courts of New York County, New York."

On October 29, 2004, FAS filed a proof of claim in the Debtor's Chapter 11 proceeding for $4,068,864 principal and interest advanced to the Debtor under the Contract, and for $8,876,500 potential indemnification thereunder. On April 25, 2005, the Debtor filed this adversary proceeding objecting to FAS's claim and asserting eight claims for relief[2]: breach of agreement; breach of implied covenants; interference with prospective economic advantage; fraud; breach of fiduciary duty; conversion; turnover; and determination of validity, priority and extent of liens.

1. MOTION TO DISMISS FOR IMPROPER VENUE

FAS maintains that the forum selection clause in its Contract with the Debtor dictates that disputes that are the subject of this adversary proceeding must be adjudicated exclusively in the state or federal courts of New York County, New York. There is no question but that all these disputes arise from the Contract containing the New York forum selection clause.

Historically, federal courts were, on public policy grounds, skeptical about forum selection clauses, the enforcement of which deprive federal courts of their duly granted subject matter jurisdiction. See ***Carbon Black Export, Inc. v. The Monrosa***, 254 F.2d 297 (5th Cir. 1958), cert. dismissed, 359 U.S. 180, 79 S. Ct. 710 (1959). This propensity changed substantially with the U.S. Supreme Court's decision of ***M/S Brenman v. Zapata Off-Shore Co.***, 407 U.S. 1, 92 S. Ct. 1907 (1972). The ***M/S Brenman*** case involved an international forum selection clause, specifying the

[2]Bankruptcy Rule 3007 provides in relevant part: "...if an objection to a claim is joined with a demand for relief of the kind specified in Rule 7001, it becomes an adversary proceeding."

London Court of Justice, affecting a United States District Court's admiralty jurisdiction. It nevertheless changed the direction of the federal courts in treating domestic forum selection questions. In ***Brenman,*** a majority of the Supreme Court held that forum selection clauses are "*prima facie* valid" and should be enforced unless enforcement is "unreasonable under the circumstances" (***Id.*** at 1913) or the clause is "invalid for such reasons as fraud or overreaching." ***Id.*** at 1916.

In ***Milk 'N' More, Inc. v. Beavert***, 963 F.2d 1342 (10th Cir. 1992), the Tenth Circuit embraces what had evolved as a post-***Brenman*** strong policy to enforce forum selection clauses as a general rule. There, the Court upheld the District Court's remand of a duly removed contract dispute with a state court venue selection clause. It recited the rule that "forum selection clauses are *prima facie* valid and should be enforced unless shown to be unreasonable." ***Id*** at 1344.

In addition to ***Milk 'N' More***, FAS relies heavily on ***In re Diaz Contracting, Inc.,*** 817 F.2d 1047 (3rd Cir. 1987), in support of enforcement of its New York forum selection clause. In ***Diaz***, Judge Higginbotham, writing for the Third Circuit, upheld a state court forum selection clause in the context of a Chapter 11 bankruptcy case. There, a Chapter 11 debtor initiated an adversary proceeding on a contract claim. The Bankruptcy Court denied a motion to dismiss, finding litigation in the state court amounted to sufficient inconvenience to the plaintiff/debtor to meet the unreasonableness standard under ***Brenman***. The District Court affirmed, finding no abuse of the trial court's discretion. The Third Circuit reversed, ruling first that this question of law was reviewable *de novo*, not on a standard of abuse of discretion. It then held that the strong policy concerning enforcement of forum selection clauses, bolstered by notions of judicial support of freedom of contract and commercial certainty, overcame any "unreasonableness" associated with extra cost and inconvenience to the Chapter 11 debtor in litigating a <u>non-core</u> matter in state court.

The same result does not necessarily obtain where the litigation in issue involves a core proceeding in the bankruptcy. Once a core proceeding is initiated in the bankruptcy court, the inconvenience and inefficiency involved in separating all or parts of the litigation from the court administering the bankruptcy case have led many courts to decline to enforce venue selection clauses. See ***In re Iridium Operating LLC,*** 285 B.R. 822 (S.D. N.Y. 2002), and several cases cited at 285 B.R. 837. See also ***In re Wheeling v. Pittsburgh Steel Corp.***, 108 B.R. 82 (Bankr. W.D. Pa. 1989). But see, ***In re Access Care, Inc.***, 333 B.R. 706 (Bankr. E.D. Pa. 2005).

Where a party invokes the core jurisdiction of the bankruptcy court by filing a proof of claim, it may not enforce a forum selection clause when met with counterclaims arising from the same transactions as its own claims. This is so even if the bankruptcy court would have been without core jurisdiction to hear the counterclaims had they been initiated in the bankruptcy court. Congress has specifically granted the bankruptcy court core jurisdiction over both "allowance or disallowance of claims against the estate" and "counterclaims by the estate against persons filing claims against the estate." 28 U.S.C. § 157(b)(2)(B) and (C).

The notion is not novel in American bankruptcy jurisprudence that a litigant, once it elects through filing a proof of claim to participate in administration of a bankruptcy case, by so doing, expands the scope of what the bankruptcy court can properly adjudicate. Since before the extension

of the bankruptcy court's jurisdiction by the 1978 Bankruptcy Reform Act, the filing of a proof of claim has subjected a claimant to adjudication of counterclaims over which the bankruptcy court would otherwise be without jurisdiction. ***Katchen v. Landy***, 382 U.S. 323, 86 S. Ct. 467 (1966).

The fact that upon filing its proof of claim and subjecting itself to the Debtor's counterclaims, FAS lost the benefit of its contractual forum selection clause works neither a hardship nor an injustice on FAS in the particular circumstances of this case. As well it was entitled to, FAS participated actively and aggressively at every stage of this Chapter 11 case. It objected to and litigated the Debtor's right to borrow post-petition. It moved to convert or dismiss this case. It contested the adequacy of the Debtor's disclosure statement. It objected to and litigated the Debtor's plan confirmation. FAS's motion to dismiss the Debtor's claims against it in order to enforce the venue selection clause in the Contract between FAS and the Debtor, raised in response to and based on the same transactions as FAS's proof of claim, is DENIED.

2. MOTION TO ABSTAIN

FAS next asks this Court to abstain from adjudicating the Debtor's counterclaim against it pursuant to 28 U.S.C. section 1334(c)(1). That statute allows the Bankruptcy Court, in its discretion, to abstain from hearing matters over which it otherwise has jurisdiction "in the interest of justice, or in the interest of comity with state courts or respect for state law." FAS and Frey each argue that the exercise of the Court's discretion under section 1334(c)(1) should be guided by the criteria set out in ***In re Asousa Partnership***, 276 B.R. 55, 74-75 (Bankr. E.D. Pa. 2002). See also, ***In re Schempp Real Estate, LLC***, 303 B.R. 866, 875-76 (Bankr. D. Colo. 2003); ***In re Western Integrated Networks, LLC,*** Adversary 02-1319, aff'd 02-CV-02407-JLK-PAC (D. Colo. May 14, 2003). They disagree on the application of those criteria.

The factors this Court considers in determining whether, in the interest of justice and comity, to abstain from hearing a matter are:

- whether the litigation involves multiple non-debtor parties
- whether state law issues predominate
- the novelty, difficulty or unsettled nature of issues of state law
- whether related litigation is pending in another court
- whether there is federal jurisdiction over the claims, apart from 28 U.S.C. § 1334
- the relatedness or remoteness of the dispute to administration of the bankruptcy case
- the substance, rather than mere formality, of assertion of core jurisdiction
- the feasibility of severing state law claims, and plugging the state court result into administration of the bankruptcy case
- the burden on the bankruptcy court's docket
- whether proceeding in the bankruptcy court promotes inappropriate forum shopping
- the right to a jury trial
- the relative efficiencies of abstaining or retaining the matter

There is no set formula in applying these factors. The Court is to exercise its discretion in light of

the circumstances of any given case, weighing particular criteria as it may find appropriate. Only the second, fifth and eighth factors inventoried above argue in favor of this Court abstaining from adjudicating the claims and counterclaims in this litigation. Furthermore, in these circumstances, FAS's initiation of this litigation by filing a proof of claim in this Court and the obvious efficiencies of this Court adjudicating the counterclaims arising from the same transactions as did FAS's proof of claim, weigh heavily against this Court exercising its discretion to abstain pursuant to 28 U.S.C. section 1334(c)(1). FAS's motion for abstention is DENIED.

3. MOTION TO DISMISS "UNRIPE" BANKRUPTCY CLAIMS FOR LACK OF SUBJECT MATTER JURISDICTION

FAS seeks dismissal of three of Frey's counterclaims pursuant to Rule 12(b)(1) for lack of jurisdiction over the subject matter. The counterclaims in question are the Debtor's objection to FAS's claim, the turnover claim (Seventh Claim), and the lien determination claim (Eighth Claim). FAS maintains that these claims are not ripe for adjudication.

FAS argues that unless and until the Debtor confirms a plan of reorganization, obtains funding to underwrite its suit against FAS, and liquidates its claims against FAS, it is pre-mature to adjudicate Frey's "bankruptcy claims" against FAS. FAS reasons that if Frey does not first accomplish the above three tasks, it will have nothing to distribute to creditors in this bankruptcy; adjudicating contested claims of creditors before that point is an academic exercise, without a true case or controversy.

Since FAS filed its motion, Frey has succeeded in confirming its plan of reorganization and has secured $400,000 to utilize in litigating its dispute with FAS. FAS's claims against Frey arise from the very same contract and transactions that give rise to this Debtor's only asset and only potential source of funds to make a distribution to creditors – – the claims against FAS. FAS's claims against Frey are anything but academic and "unripe." They involve real controversy that is an essential part of liquidating or rendering worthless this Debtor's only scheduled asset. FAS's motion to dismiss for lack of subject matter jurisdiction due to a lack of case or controversy is DENIED.

4. MOTION TO DISMISS FOR FAILURE TO STATE A CLAIM

FAS seeks dismissal of Frey's Fourth (fraud) and Seventh (turnover) Claims for failure to state a claim under Rule 12(b)(6). Frey's fraud claim alleges that FAS made specific promises to perform under its contract with Frey, knowing at that time that it had no intention to perform. Frey relied to its detriment on these representations. FAS argues that these allegations lack the necessary particularity under both Tenth Circuit and New York law to state a claim.

In the context of commercial contracts, it is rare that one's alleged failure to perform as promised constitutes fraud. That reality is, however, more often a matter of proof than pleading. Establishing the elements of fraud with respect to a representation concerning a future event, as opposed to a present or past fact or condition, poses particularly difficult problems of proof.

Nonetheless, Frey's Fourth Claim for Relief contains allegations of fraud with sufficient particularity to withstand a Rule 12(b)(6) motion. FAS's motion to dismiss FAS's fraud claim is DENIED.

Finally, FAS seeks dismissal of the Debtor's turnover (Seventh) counterclaim for failure to state a claim. That claim seeks, pursuant to 11 U.S.C. § 542(a), to have FAS turnover to the Debtor the disputed amounts Frey claims are due under its Contract with FAS. Section 542 turnover proceedings are not an appropriate procedure to liquidate contract disputes. Frey fails to state a claim for which a turnover order could properly enter. FAS's motion to dismiss Frey's Seventh Counterclaim is GRANTED.

DATED:

BY THE COURT:

/s/
A. Bruce Campbell
United States Bankruptcy Judge